No. 10088.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CONSOLIDATED ROYALTIES, INC., a corporation, and C. B. CALLAHAN,

Appellants,

vs.

HARRY ASHTON, Trustee of the Estate of Deep Hole Drilling Corporation, bankrupt, *et al.*,

Appellees.

AMICUS CURIAE BRIEF OF JOSEPH J. RIFKIND IN SUPPORT OF APPELLEE.

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Statement of Case.

The bankrupt was an operating lessee under an oil and gas lease. The bankrupt incurred divers obligations in the drilling and operation of its Well No. 1 aggregating in excess of $4000.00. The bankrupt as operating lessee sold to appellant a fractional interest in the production from said Well No. 1 aforesaid. The bankrupt also incurred divers obligations in the drilling of Well No. 2 located upon the same leasehold premises. [Stipulation of Facts, Tr. pp. 25 to 32, incl.] That prior to the execution of the assignment of said fractional interest, by the bankrupt as operating lessee to the appellant, an applica-

tion was made to and a permit was obtained from the Commissioner of Corporations authorizing the bankrupt to issue its securities, a copy of the proposed assignment being attached to said application, to evidence the character of securities proposed to be issued by the bankrupt. [Application for Permit to Issue Securities, Tr. pp. 33 to 40, incl.] The assignment makes no attempt to convey a fractional interest in the leasehold estate, only a percentage of the production is assigned from the well drilled, operated and managed by the bankrupt. The debts incurred by the bankrupt remain unpaid.

ARGUMENT.

POINT 1.

In re Lathrap, 61 Fed. (2d) 37 Has Not Been Overruled by Laugharn v. Bank of America, 88 Fed. (2d) 551.

The basis of appellant's argument is that the case of *In re Lathrap,* 61 Fed. (2d) 37 has been overruled by the case of *Laugharn v. Bank of America,* 88 Fed. (2d) 551. A cursory reading of the case of *Laugharn v. Bank of America. supra,* because of *dictum* therein, might give support to such contention. An analysis of the case of *Laugharn v. Bank of America, supra,* however, clearly shows that it does not overrule the earlier case of *In re Lathrap, supra.*

One of the several considerations before the Circuit Court when it rendered its decision in the case of *In re Lathrap, supra,* was whether an owner or lessee had present title to oil in place, that particular problem not having previously been determined by the state courts of

last resort. The Supreme Court of the State of California, in *Callahan v. Martin,* 3 Cal. (2d) 110, decided after *In re Lathrap, supra,* but before *Laugharn v. Bank of America, supra,* that both the lessor and the lessee had title to oil in place. The Circuit Court in *Laugharn v. Bank of America, supra,* does not overrule its previous decisions of *In re Lathrap, supra,* but merely states that *insofar* as its prior decision in *In re Lathrap, supra,* is *inconsistent* with the case of *Callahan v. Martin, supra,* it is overruled. We quote from *Laugharn v. Bank of America, supra,* at page 553, as follows:

> "As the law then stood, this court was presented with two cases involving the nature of royalty interest holder's right whose interest was acquired from a lessee in an oil and gas lease. It was held that neither the owner nor the lessee had any present title to oil in place, and therefore the assignment by the lessee did not convey the present title. In re Lathrap (C. C. A. 9), 61 F. (2d) 37; Bank of America Nat. Trust & Savings Ass'n v. Fisher (C. C. A. 9) 61 F. (2d) 53.
>
> "Thereafter, the Supreme Court of California, in Callahan v. Martin, 3 Cal. (2d) 110, 43 P. (2d) 788, 792, 101 A. L. R. 871, considered the same issue and held that after an oil and gas lease, both the lessor and the lessee had an interest in real property capable of assignment or conveyance. * * *
>
> "The determination of the interest created by an oil and gas lease is the determination of rules of property, Guffey v. Smith, 237 U. S. 101, 113, 35 S. Ct. 526, 59 L. Ed. 856. It is our duty to follow the law of the state established by legislative enactment, or decision of the highest court of the state, with respect to property rules. * * *

"* * * Therefore, we must and do overrule the prior decisions of this court *in so far as they are inconsistent* with the settled law of California as adjudged by the California courts. On this basis we hold the assignments in the instant case to be conveyances of an interest in real property, and not to be executory contracts."

It should also be noted that in *Laugharn v. Bank of America, supra*, unlike in the present instance, the bankrupt had not made an assignment of a fractional interest, but had assigned the entire residuary interest in the leasehold estates. Under that circumstance, it would not have been necessary for the bankrupt to have obtained a permit from the corporation commissioner, as is necessary in the case of the issuance of fractional interests by an operating lessee. We quote from *Laugharn v. Bank of America, supra*, page 552, as follows:

"On the same date Huntington executed and delivered to appellee, as security for the loans made to itself and to Lion, and as security for future loans which might be made to itself, Lion and to Tide, an assignment, which provided that Huntington 'does hereby assign, transfer and convey * * * *all* its right, title and interest in and to all crude oil, gas and other hydrocarbon substances produced from that certain oil well known as Huntington Shore Oil Company Well No. 1, situated upon (lot 2 above mentioned) * * *'"

The holding in the *Laugharn v. Bank of America, supra,* case, in so far as it relates to an interest reserved by the landowner lessor or to any fractional interest issued by the landowner lessor from that reserved under the lease, is supported by *Callahan v. Martin, supra,* and subsequent cases of courts of last resort of the state. The holding in *Laugharn v. Bank of America, supra,* in so far as it relates to fractional interests issued by an operating lessee, is not supported by *Callahan v. Martin, supra.* We quote from *Callahan v. Martin,* 3 Cal. (2d) 110 (1935):

> *"It is unnecessary here to determine the effect of our decision in the instant case on the nature of royalty interests created by an operating lessee, rather than by the landowner-lessor, as in the instant case.* This question was involved in such cases as Western Oil, etc. Co. v. Venago Oil Corp., 218 Cal. 733 (24 Pac. (2d) 971, 88 A. L. R. 1271); Black v. Solano Co., 114 Cal. App. 170 (299 Pac. 843); Merrill v. California Petroleum Corp., 105 Cal. App. 737 (288 Pac. 721). In these cases the doctrine of potential possession of personality—the oil severed from the land and brought to surface—was applied. This doctrine has since been abolished by the adoption of section 5 of the Uniform Sales Act, section 1725 of the Civil Code."

and in *Schiffman v. Richfield Oil Co.,* 8 Cal. (2d) 211, p. 222 (1937):

> "In Western Oil etc. Co. v. Venago Oil Corporation, *supra*, we did not hold that the percentage as-

signments vested in the assignees an interest in real property. Since our decision in that case we have held that certain royalty assignments *made by landowner-lessors* operated as transfers of interests in real property. (Callahan v. Martin, 3 Cal. (2d) 110, 101 A. L. R. 871; Standard Oil Co. v. J. P. Mills Organization, 3 Cal. (2d) 128; Dabney-Johnston Oil Corp. v. Walden, 4 Cal. (2d) 637.) Respondent urges us now to hold that said cases establish the character of the assignments to him, which were made by a lessee, in this case a sublessee, rather than by a landowner-lessor. *For reasons which we will state we are unwilling in the instant case to thus apply the cited cases.*"

and in *Dougherty v. Calif. Kettleman Oil Royalties, Inc.*, 9 Cal. (2d) 58, p. 76 (1937):

"It is perfectly clear that the term 'real estate' as used in the constitutional provision only applies to freehold interests. It does not apply to interest less than a freehold, such as an interest for a term of years. *It has quite recently been held by this court that an oil and gas lease for a term of years is not real estate;* that although such a lease creates an interest in real property, or in real estate, being less than a freehold, it is a chattel real which is personal property. * * * *Obviously a royalty interest, such as is here involved, cannot rise to a greater dignity than the lease upon which it is predicated.*"

POINT 2.

The Purchasers of Fractional Interest in Production From an Oil Well Are Investors and as Such Their Rights Are Subordinate to the Rights of Creditors.

The issuance and sale of assignments of royalty interest is a form of financing which was originally conceived by small oil operators to circumvent the Corporate Securities Act of the State of California. That such assignments of royalty interest are now expressly covered by the Corporate Securities Act is not disputed, in fact the act is too clear and the cases too numerous. Whether holders of assignments of royalty interest are more analogous to preferred stockholders or limited partners or whether the holders of assignments of fractional interest in production have an interest in real property or in personal property, is of no importance if they in fact are investors in the project of the bankrupt. It cannot be disputed that investors of this character are dependent for their return upon the success or failure of the bankrupt's drilling and operations. The Supreme Court of the State of California in the case of *Domestic & Foreign Petr. Co. v. Long*, 4 Cal. (2d) 547, says:

> "Indeed, in the absence of any specific provision in the Corporate Securities Act *expressly bringing oil interests within the definition of security; the individual owners of an oil lease who, as in the instant case, transfer to others the right to participate in the proceeds from an oil production enterprise*

> *to be conducted by the lessees, create an investment contract, or certificate of interest or participation, as those terms are defined and explained in the cases cited in the above paragraph.* The specific reference in the definition of 'security' as it stood at the time of the transaction herein to 'certificate of interest in an oil, gas, or mining lease', and in the act as it now reads to 'certificate of interest in an oil, gas, or mining lease', *may seem to bring within the definition instruments besides those which represent a right to share in the proceeds of an oil production enterprise to be conducted by others* * * * instruments of the class involved in the instant case are 'securities' under the law."

and again in the case *People v. Rubens,* 11 Cal. (2d) 578 the Court says:

> "Under circumstances very similar to those which exist in the present case it was determined in the recent cases of People v. Craven, 219 Cal. 522, and Domestic & Foreign Petroleum Co. Ltd. v. Long, 4 Cal. (2d) 547, *that contracts which were called 'grant deeds' assigning undivided interests in oil and gas leases entitling the holders thereof to participate in the proceeds of the petroleum produced by the vendor from the land were in fact 'securities'* within the meaning of the Corporate Securities Act which are prohibited from being transferred or sold without first procuring a permit therefor from the corporation commissioner."

In the case of *In re Hawkeye Oil Company,* 19 Fed. (2d) 151, involving a similar type of investment certificate the Court says:

> "The primary problem presented by these petitioners for review is the ascertainment of the status

and rights of the holders of 'participating operation certificates' issued or assumed by Hawkeye Oil Company, bankrupt, the owner of bulk and service stations for the storage and sale of gasoline. The relationship of the certificate holders and of the bankrupt arises out of contract. The rights of the holders are fixed, and measured by the terms, substance, and effect of the contract. That contract, unless modified or enlarged by mortgage, is found in the certificates, which provide:

* * * * * * * *

"'To provide the fund hereinbefore mentioned, from the daily receipts of said station there shall be set aside in a bank one cent (1¢) on each gallon of gasoline and five per cent (5%) on all other merchandise sold by said station, and the fund thus created shall be distributed every month among the registered holders of these certificates in said station as their interests may appear.'

* * * * * * * *

"* * * The funds so deposited were claimed by both the certificate holders and the general creditors of the insolvent defendant. Judge Schoonmaker said that the certificates evinced an attempt to create a novel type of stock ownership superior in its claim to corporate assets to that of the general creditors, and that, 'on general principles of public policy, we believe that this contract is void as against the claims of general creditors. To permit corporations, by reason of certificates of this kind, to appropriate corporate assets to certain classes of creditors or shareholders, whatever they may be, would be an absolute fraud upon the general creditors of the corporations concerned and would permit the creation of a special type of preferred creditors not contemplated by law.

> If enforceable at all, this contract should only be enforced as against the stockholders of the company. and not against the rights of creditors who have dealt with the corporation in the ordinary way. To give validity to such a contract would be to establish a legal vehicle for corporation fraud and illegal preference of creditors. These certificate holders cannot claim any part of the corporate funds to the detriment of general creditors.' * * *"

And in *Brownie Oil Co. v. R. R. Commission,* 240 North Western, p. 827, the Court says:

> "This is a device for financing a corporation. The inducement to secure this financing is the promised creation of a fund which will later be distributed to the person making the investment or furnishing the financing. This person waives his right to any interest or dividends as such, but he does invest with the hope or expectation that the money invested will be returned to him together with some payment for its use. He acquires the right to have the fund accumulated and to receive his distributive share when it is accumulated. He accepts the risk that the enterprise will be unable to get into operation and that the period of its operation will be neither sufficiently long nor successful to bring him the expected returns. In State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N. W. 937, 938, the court said: 'Placing of capital or laying out of money in a way intended to secure income or profit from its employment is an "investment" as that word is commonly used and understood.' "

In *People v. McCalla,* 63 Cal. App. 783, where deeds were issued to specific parcels of real property, the pur-

chasers in addition were given the right to participate in certain operations of the grantor, the court says:

> "The corporation, upon or with the lands of others, was to carry on a business for profit, it being agreed that a part of the income—five per cent—should be retained by the corporation and that the balance, after deducting all necessary and proper expenses, should be distributed to the land owners. Though the case differs in its outward form from that of a corporation engaged in extracting wealth from its own land, selling the produce and dividing the net profits among its stockholders in the shape of dividends, still, in the essentials, there is no material difference between this case and that of a corporation so engaged in exploiting its own land. The difference is in the bark, not in the pith."

Also in *Warren v. King,* 108 U. S. 389, the court says:

> "His (preferred stockholder's) chance of gain by the operations of the corporation, throws on him as respects creditors, the entire risk of the loss of his share of the capital, which must go to said creditors in case of misfortune. He cannot be both creditor and debtor by virtue of his stock."

Also *Newton National Bank v. Newbegin,* 74 Fed. 135, the court says:

> "Where a corporation becomes bankrupt, the temptation to lay aside the garb of the stockholder on one pretense or another and assume the role of a creditor is very strong, and all attempts of that kind should be viewed with suspicion."

That the Circuit Court in *Laugharn v. Bank of America, supra,* despite loose language and *dictum* to the con-

trary, did not intend to overrule its previous decision in *In re Lathrap, supra,* in so far as that case holds, that rights of holders of fractional interests issued by an operating lessee are subordinate to the rights of general creditors of the operating lessee who becomes bankrupt, is evidenced by its decision wherein it says, in *Sasso v. H. C. Goldman,* 100 Fed. (2d) 210:

> "This court said in In re Lathrap, 61 F. (2d) 37, that it is not necessary that claimants in bankruptcy be regarded as 'technically in the nature of joint adventurers or stockholders, in order to determine that their status is inferior to that of general creditors, who have dealt with the bankrupt in good faith and only for a normal profit.' However, the claims there were based on the ownership of royalty interests. The claimants, as the court pointed out, were referred to even by themselves, as 'investors', and were thought to bear a close analogy to preferred stockholders. Similarly, in Bank of America v. Fisher, 9 Cir., 61 F. (2d) 53, it was determined that the claimant and the debtor were joint adventurers."

The Supreme Court of the State of California in *Schiffman v. Richfield Oil Co.,* 8 Cal. (2d) 211 (1937) clearly recognizes that the property interest of royalty holders of an operating lessee may be subordinated to the rights of creditors, to-wit:

> "If the effect of the percentage assignments was to create an undivided interest in the assignees in the leasehold estate, that is, in the right of profit to drill for and produce oil, notwithstanding it was understood that the lessees should retain exclusive management of the production enterprise, then as

> to such assignees the lessees are operating the well as their agents, or in some representative capacity. *If the lessees are thus operating the well, the problem suggests itself as to the personal liability to third persons of the percentage assignees for debts and liabilities of the production enterprise.* * * *"

In *Wortley v. Wood-Callahan, supra,* the court stating on page 469, as follows:

> "The assignment of the leasehold by Wortley to Wood-Callahan was complete and without reservation of any kind as to Wortley."

and again on page 470, as follows:

> "In support of this proposition the appellant cites In re Lathrap, 61 Fed. (2d) 37. The factual distinction between those cases and the instant one is the very thing that defeats the claim of appellant. There the question arose as a result of bankruptcy proceedings against the lessee, and at the time of the action the lessee held the lease. Here the deceased had nothing at the time of his death."

We also refer to the case of *Schwartz v. Hatch,* 45 Cal. App. (2d) 510, at pp. 519 and 520, as follows:

> "In re Lathrap, 61 Fed. (2d) 37, can readily be distinguished from the case at bar. There the court held that in bankruptcy, the proceeds of the oil should be distributed to the general creditors in preference to persons holding royalty certificates similar to those issued by Hub Ltd. It did not consider the question of whether or not the certificate holders would be personally liable to creditors, although there are cases in other states which seem to so hold. But the chief distinguishing feature of In re Lathrap and these

other cases is that there were creditors who had dealt with the company in good faith and 'only for a normal profit' (61 Fed. (2d) p. 44). Thus the rule there applied seems to be limited to credit 'for a normal profit'. Again in the Lathrap case, page 44, the court uses this extremely significant language: 'These per cent holders are junior in right to the general creditors who furnished commodities to the bankrupt *not at speculative but at normal profit.*' (Italics added.) Here, the actions of the defendants were not for a normal profit but for a highly speculative one, a percentage interest in the production of the well when completed."

In *La Laguna v. Dodge,* 18 Cal. (2d) 132 the Supreme Court held that although an operating lessee had issued various overriding royalties, that the operating lessee retained the management and control and could without the consent of the holders of such fractional interest in the production quitclaim the leasehold premises.

"Defendants contemplated the purchase of a speculative interest in real property which they intended should be determinable by the lessees. * * * Continued drilling might prove that no oil could be produced from the land in question. * * * We do not see how the surrender of the leasehold by the lessees imposes any uncontemplated risk upon the holder of the overriding royalty. * * * In the present case, however, the surrender of the leasehold by quitclaim deeds operated to terminate the interests of the defendants, as well as the interest of the lessees, in plaintiff's land."

We think this decision clearly illustrates that whatever the property rights of holders of fractional interest in oil to be produced, whether such interest be real or personal property, the same at times necessarily becomes subordinate to the rights of third persons dealing with the operating lessee, in the case cited they were subordinated to enable the operating lessee to quitclaim, in the instant case they are likewise subordinate to the payment of creditors of the operating lessee. The fact that such percentage interest may constitute an interest in real property does not preclude such interest being subordinated to the payment of the operating lessee's indebtedness.

Conclusion.

If appellant's theory be correct, then an operating lessee could assign fractional interests aggregating 99 percent, each one of the holders of interests aggregating 99 percent would be entitled to his portion of the production free and clear of all obligations arising from the drilling and operation of the well, leaving the holders of claims for labor, material and other obligations arising from drilling and operating the well without any assets to resort to in satisfaction of their claims. I do not believe that any logical or equitable reasoning can be found to support such a conclusion nor do the authorities sustain such a position. Whatever may be the contractual relationship between the bankrupt and his investors, such investors in the event of final difficulties, whether bankruptcy ensues or not, must be relegated to a subordinate position

to creditors of the enterprise of the operating lessee. These investors whether they be called grantees, holders of assignments, overriding royalties, limited partners, mining copartners, preferred stockholders or whatnot, are none the less investors, speculating their funds upon the success or failure of the operating lessee, as such they cannot and should not be permitted to reap the benefits of the operating lessee's endeavors without being compelled to sustain the corresponding losses if the project proves unsuccessful. Italics in citations throughout are ours.

Respectfully submitted,

Joseph J. Rifkind,
Amicus Curiae.